

Private sector

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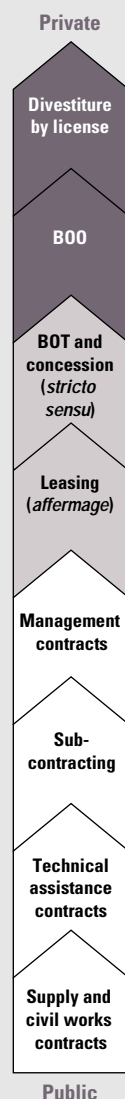
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Concessions—The Way to Privatize Infrastructure Sector Monopolies

RANGE OF PRIVATE SECTOR OPTIONS



Concession-type arrangements are well suited for privatizing sectors with monopolistic characteristics.¹ Under this approach, the state (or municipality or other public entity) delegates to the private sector the right to provide a service, yet retains some control over the sector by incorporating in a concession contract or license the terms and conditions—including the rights and obligations of the service provider—that will govern the infrastructure project or company. This Note outlines the concession-type approach and some of its operational implications.

Options for private sector provision

There is a continuum of options for involving the private sector in the provision of infrastructure services, as illustrated by the figure on the left.² At the base (in white) are supply and service contracts, which tend to be of short duration and require less private commitment than the options higher in the continuum. The private contractor is not directly responsible for providing the service, but instead for performing specified tasks, such as supplying inputs, constructing works, maintaining facilities, or billing customers. In this first category, private sector involvement is highest in management contracts. When these include mechanisms linking the contractor's compensation to the performance of the utility it manages, they come closer to the concession-type arrangements (in pink and purple in the figure) that are the focus of this Note.

The first of these arrangements is the lease-and-operate (or *affermage*) contract, under which the private contractor is responsible at its own risk for provision of the service, in-

cluding operating and maintaining the infrastructure, typically against payment of a lease fee. In the second, concession *stricto sensu*, the private contractor is also responsible for building and financing new investments. At the end of the concession term, the sector assets are returned to the state (or municipality). The term BOT (build-operate-transfer) is often used to refer to greenfield concessions, and ROT is sometimes used to describe concessions in which investments entail primarily rehabilitation (hence the "R") rather than construction.

BOO (build-own-operate) is a similar scheme, but does not involve transfer of the assets. Divestiture, finally, involves the transfer to the private sector of the ownership of existing assets and the responsibility for future expansion and upkeep. In both cases, the private company is responsible for financing and carrying out the investments required to meet the obligations specified in its license or by the regulator.

In all these concession-type arrangements (hereafter, concessions), a public entity, typically the state or a municipality, grants the right and the obligation to provide an infrastructure service to a private company (the concessionaire).³ The service, whether gas, power, water, transport, sanitation, or telecommunications, is provided under terms and conditions specified in a contract or license. The private sector takes over operational responsibility and at least part of the commercial risk of service provision. The concessionaire is by and large held responsible for achieving specified results in service delivery and is given some freedom to choose the means for meeting those targets.





Sizing up concessions

Despite these common features, important differences do exist between the different types of concessions. These variations can have important operational implications.

Responsibility for new investments

Although the responsibility of the private sector under a concession always includes the operation and maintenance of the system or facilities and the supply of the infrastructure service, it may or may not include the design, construction, and financing of the new infrastructure.

Legal ownership

The legal status of assets built and financed by the private operator may also vary. Under the traditional French concessions, for example, the state owns these assets from the moment they are built, but the private operator retains full control over them until the end of the concession period. In other cases, including many BOT or ROT schemes and even some French concessions, the legal ownership of assets built and financed by the private operator will remain private until their transfer to the state at the end of the concession term. Finally, under BOO contracts and divestiture schemes, these assets remain private. Private ownership may give investors more protection and facilitate the financing of concessions by making these assets available as collateral.

Duration

Leases, BOTs, and concessions *stricto sensu* (in pink in the figure) are generally granted for fixed periods. At the end of the specified term, most assets (including those financed by the concessionaire), as well as the right to carry out the activity, return to the public entity. In France and other countries with a long tradition of using concessions, however, these contracts are often renewed or retendered.

The contracts' duration tends to reflect the number of years investors need to recoup their investment. That is the case for French-style concessions, under which assets return to the state at the end of the period free of charge or for a nominal amount. Lease-and-operate contracts (*affermages*), under which the public authority remains responsible for financing most investments, are shorter (ten to fifteen years) than greenfield BOTs or concessions *stricto sensu* requiring major up-front capital expenditures; these can exceed thirty years. Similarly, the transfer of existing sector assets (for example, a distribution network or a parallel bridge) free of charge at the time of the award not only reduces the relative size of new investments. It also provides a free cash flow for financing these investments, allowing a shorter payback period and a shorter contract period.

Matching the contract term to the amortization of investments is not essential, however. The government generally reserves the right to terminate the contract before the end of its normal term. In addition, infrastructure services require continuous investment that cannot be adequately predicted decades in advance. Investments will almost always have to be made toward the end of the concession that cannot reasonably be amortized before its expiration. Moreover, the true value of the business is in no way limited to the value of the unamortized assets built by the incumbent. It also includes intangible assets, know-how, reputation, and billing and collection systems.

Schemes should thus be designed with proper incentives for maintenance of the facilities and for valuation of assets that have not been fully amortized. For example, a payment might be made by the public authority to the private operator on the basis of an evaluation by independent experts. Another option would be to stipulate that the concessions awarded will be rebid periodically—as the Argentines have done in the power distribution sector. Though the Argentine concessions are for a period of ninety-five years, they are rebid after the first

fifteen years and every ten years thereafter. If the incumbent bids the highest price, it retains the concession. If it doesn't, the highest bidder pays the amount of its bid to the incumbent, not to the public authority. In this way, assets that are not fully amortized are valued by the market, not at the discretion of the state or a regulator.

In monopolistic sectors, even BOOs and full divestiture do not imply permanence. The private company does have indefinite ownership rights to the assets. To be allowed to provide the service, however, it typically also needs an operating license, which the government can withdraw, revoke, or not renew. In England and Wales, for example, the privatized water utilities have a license in perpetuity, but the government can terminate these licenses after twenty-five years with ten years' notice. In addition, licenses can be revoked at any time for noncompliance. The difference between a traditional fixed term concession (in pink in the figure) and an indefinite divestiture thus may not be as big as it might at first appear.

Bulk or retail supply

In its classical (or narrow) sense, a concession is a public utility: it provides a public service to end users. Direct payment of the concessionaire by the users, who are not party to the concession contract, was seen as a defining feature of this scheme. Examples of such concessions include bridges, tunnels, toll roads, and water and power distribution systems.

In the broader sense suggested by this Note, concession-type arrangements also include schemes under which an independent producer of, say, power or bulk water sells its product to a single buyer, the public utility. Examples include the fifty-year bulk water supply BOT in Casablanca signed in 1949 and the many private power deals signed in recent years in such countries as China, Indonesia, Pakistan, and the Philippines. The risks associated with a public utility and a bulk supply concession differ significantly.⁴

Regulatory implications

Concession arrangements embody a regulatory framework and should be seen as an integral part of economic regulation, rather than as a substitute or alternative. The key elements of the regulatory framework, including tariffs, degree of competition, interconnection regime, and performance targets, are defined in the concession contract or operating license. Because of the element of monopoly, public service obligations tend to include detailed specifications on the service to be provided, the obligation to supply, equal treatment of users, continuity of service, and so on. In consideration of these obligations, concessions often grant certain exclusive rights to the private operator.

These terms need to be monitored and enforced and may need to be revised from time to time to reflect changing conditions. Thus, concessions (or the legal framework that governs them) may grant the public authority or a regulator a certain amount of discretion and, at the same time, provide recourse against the decisions of the authority or regulator. In view of concessions' public service nature, public authorities will often reserve the right to unilaterally modify some of the provider's obligations or even to terminate a concession before its stipulated term.⁵

Whatever the approach, all concessions include some form of regulatory mechanism. Under the French model, the concessionaire is regulated in part by the public authority that awarded the concession and to a lesser extent by that authority's supervising agencies. The authority and agencies themselves are kept in check by the political process (including elections) and the courts. Concessions also may be regulated by independent regulatory bodies, as in Argentina. The selection mechanism can play an important regulatory role by awarding the concession initially on a competitive basis and by putting it up for bid periodically thereafter. Indeed, repeatedly auctioning off the concession right allows monopoly rents to be extracted without discretionary intervention by the regulator or government.⁶ Self-regulation also may



play an important role: most concessionaires are concerned with protecting their reputation (or their shareholder's) in the market.

A customized instrument

The concession is a flexible mechanism that can be designed to overcome a broad range of obstacles to private participation in infrastructure. The option of leaving formal ownership of existing sector assets to the state makes it particularly useful in countries in which the law or constitution excludes private ownership of specific infrastructure assets. For the same reason, recourse to a concession is an elegant solution when the sale of the infrastructure company or assets would not fetch the “right price” and would expose the government to accusations of a giveaway. Public ownership may also provide tax advantages where tax laws treat public ownership more favorably—for example, by allowing a concessionaire to depreciate investments faster than if it owned them.

Because concession-type agreements can be made as specific as required, they are well suited to situations in which more general and vaguely defined regulatory approaches would deter investors. And they can be tailored to allocate risks in a variety of ways to give investors the comfort they need to venture their capital in specific countries and markets.

The flexibility of this mechanism is clearly one of its main strengths, but it can also be perplexing. Designing a scheme that strikes the right balance between the interests of the investors, the consumers, and the public authorities and that fits the conditions of the sector and the country concerned is pivotal. It requires a clear identification of the objectives and of the tradeoffs that must be taken into account to achieve them. Blueprints and model contracts can rarely be transposed from one country and sector to another. With time, countries will develop their own precedents, and the process will become easier. But each concession is likely to remain a special case requiring special attention and unique features.

In sum, what matters most are the incentives built into a specific scheme, not whether it is labeled as a concession, a BOT, a privatization, or by any other name.

- ¹ The concession technique is less suited to situations in which competition can and should be introduced *in* the market—distinct from competition *for* the market through competitive bidding for the exclusive right to provide a service. Where multiple firms must compete with one another for the provision of services, competitive discipline tends to reduce the need for economic regulation. Such firms should operate on a level playing field under a uniform regulatory framework (such as antitrust legislation), not under the terms of individual regulatory deals that would discriminate among players. And, under normal circumstances, the state would no longer have the option to terminate the operator's right to provide the service.
- ² With any of these schemes, private participation would be less where the state or other public entities are shareholders of the service provider.
- ³ Concessions have also been granted to autonomous public entities, for example, ADM, the Moroccan toll road company. In France, state-owned companies are concessionaires of toll roads and hold monopoly concessions in the gas, power, and railroad sectors. In other cases, the state is a minority shareholder of the concession company (for example, SEEG, the Conakry, Guinea, water company).
- ⁴ Collecting from hundreds of thousands of households, enterprises, and administrations may be more difficult, but in addition to strong incentives to collect, the concessionaire possesses the tools required to make users pay (including the right to cut off service in case of arrears). Exposure to a single buyer, by contrast, may require more government guarantees or comfort, especially when the buyer is a state enterprise that may be uncreditworthy and protected from the concessionaire's power to cut off service. In a public utility concession, the private operator bears the market risk directly, such as the risk of a drop in demand. With a single buyer, this risk is usually taken by the public utility through take-or-pay arrangements, although where the utility may limit its take to a contractual minimum that is lower than capacity, the private operator would still face a residual demand risk.
- ⁵ Some form of compensation is usually called for when modifications create more onerous operating conditions or in case of early termination.
- ⁶ See also the section above on duration of concessions and Anthony Dnes, “Franchising and Privatization,” *Private Sector* (March 1995). The competitive award of a concession is a form of franchising, as this term is used in the economics literature.

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